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ALABAMA POWER COMPANY

In re: Public Proceedings established to consider any necessary modifications to the Rate Stabilization and Equalization mechanism applicable to the electric service of Alabama Power Company.

DOCKETS 18117 and 18416

REPORT AND ORDER

BY THE COMMISSION:

I. Introduction

On February 13, 2013, this Commission voted to hold a series of public meetings concerning the operation and utilization of the Rate RSE ("Rate Stabilization and Equalization" or "RSE")) mechanism applicable to Alabama Power Company ("Alabama Power" or the "Company"). The purpose of these meetings was to allow the Commission the opportunity to assess the current effectiveness of Rate RSE and consider whether there was sufficient cause to initiate formal proceedings regarding this matter. Subsequently, the Commission issued a notice setting forth the dates of the meetings and the associated topics scheduled for discussion. A number of interested parties were thereafter granted participant status in the proceedings and

were provided a full and complete opportunity to participate.¹ In addition, the public was afforded an opportunity at the close of every meeting to pose questions or offer comments.

This report reflects our consideration of the information received at these meetings and the recommendations that we are making as a result. Although we have endeavored to recite the relevant facts and considerations underlying this report, practical limitations constrain our ability to address each and every position, comment or statement received. Even so, we would emphasize that all information presented to us relevant to the issues noticed for review has been afforded full and fair attention and careful deliberation.

II. Procedural History and Background

The first public proceeding was held in Montgomery on May 8, 2013.² The topics noticed for this day included an overview of Alabama Power, the fundamental goals of Rate RSE and the mechanics of the rate. These topics were selected for the first meeting to provide foundational information for subsequent meetings. Presenting on behalf of the Company were Zeke Smith and Christine Baker.³ Mr. Smith discussed the history of the Company, emphasizing its customer focus and commitment to economic development. He also overviewed the regulatory, political and legal circumstances that led to the adoption of Rate RSE, as well as its

¹ In addition to the Office of the Attorney General, the interested parties that participated in the proceedings included: AARP, AFL-CIO, Alabama Coal Cooperative, Alabama Environmental Council ("AEC"), Alabama Industrial Energy Consumers, Alabama Policy Institute, ARISE Citizens' Policy Project ("ARISE"), Generation America, JobKeeper Alliance, League of Women Voters of Alabama, League of Women Voters of Mobile, Manufacture Alabama, NAACP-Birmingham, National Federation of Independent Businesses, Partnership for Affordable Clean Energy ("PACE"), the Prattville Tea Party, Southern Christian Leadership Conference, Southern Environmental Law Center on behalf of GASP, Inc. and the Southern Alliance for Clean Energy ("SACE"), The Eagle Forum, The 60 Plus Association, and the United Mine Workers.

² This and each of the subsequent proceedings were presided over by President Twinkle Address Cavanaugh, Commissioners Jeremy H. Oden and Terry L. Dunn, and Executive Director and Chief Administrative Law Judge John A. Garner.

³ Mr. Smith is Executive Vice President – External Affairs, and Ms. Baker is a Manager in the Company's Regulatory Department.

fundamental purposes. Those purposes include: (i) the stabilization of electric rates through a mechanism that facilitates smaller, more predictable retail rate adjustments, as opposed to larger rate requests typical of previous rate case practices; (ii) the restoration of the Company's financial integrity, including its ability to provide reliable service to meet the needs of customers; (iii) the provision of a reasonable opportunity for the Company to earn a fair return on assets devoted to public service through limited periodic adjustments (increases and decreases); and (iv) the enabling of the Commission and its staff to monitor more closely the Company's daily operations and devote resources to regulatory oversight.

Ms. Baker discussed the mechanics of Rate RSE. Among other points, she demonstrated that the basic components of this formula rate are the same as those examined in more traditional ratemaking proceedings. She also discussed the various protections and restrictions that are embedded in the rate, such as the limitation on the Company's common equity ratio, the restrictions on the magnitude of any annual upward adjustments, and the potential for refunds in the event the Company earns in excess of the return range (without a countervailing provision requiring adjustment in the event the actual return falls below the range).⁴

At this meeting, the Commission's Electricity Policy Division staff discussed the detailed oversight applied to the Company's ongoing operations. Those processes and procedures reflect the requirements of Rate RSE as well as controls developed by staff. For example, certain aspects of staff's review are annual in nature and center upon required submissions under Rate

⁴ Rate RSE is currently restricted in its operation so that increases in the Company's common equity ratio in excess of 2½ percentage points in any 12-month period used to compute the RRCE is not recognized in the operation of the rate. Further, if any increase attributable to infusions of equity capital (and not attributable to net increases in retained earnings or retirement of outstanding debt) causes the Company's common equity ratio to exceed 45 percent, then such increase is not recognized in the operation of the rate.

RSE. These include staff's evaluation of the Company's revenue forecast and its capital and O&M budgets, staff's participation in the annual meeting concerning the Company's submittal under the rate, and staff's analysis of the Company's submission of actual results for the prior year. In addition, staff annually reviews the Company's cost of service study, which is reconciled to the Company's audited financial statements. Furthermore, staff meets with Alabama Power representatives annually to review a set of metrics that assess the Company in a number of key areas, such as safety, generation, transmission and distribution, financial performance, and customer satisfaction. This annual metrics review occurs every fall, prior to the annual Rate RSE filing.

On a monthly basis, staff receives detailed accounting schedules drawn from the Company's books and records, which facilitate its oversight of projected costs and revenues to identify variances and trends requiring further inquiry. Along with other information, staff develops Rate RSE projections that are presented to the Commission at its monthly meetings. In conjunction with these annual, monthly and daily activities, staff continuously requests information from Alabama Power representatives, while also utilizing analytical reports, industry research, and other sources that contribute to its knowledge and understanding of the Company's business.

None of the other participants offered witness testimony on these topics and there was minimal questioning of the Company's witnesses. With regard to staff's presentation, PACE inquired whether staff had ever encountered difficulty receiving information requested from the Company. Staff testified that the Company consistently responds to all of its inquiries in a timely manner.

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The second and third public proceedings were held in Tuscaloosa on June 18, 2013, in the form of an afternoon and an evening session. The topics noticed for these proceedings included overviews of the Company's generation, transmission and distribution operations, and customer service function. During the afternoon session, Jim Heilbron presented an operational overview of the generation function.⁵ As part of this presentation, Mr. Heilbron outlined Alabama Power's generation mix, explained the application of economic dispatch to system resources, and discussed several metrics highlighting the cost-effectiveness and reliability of the Company's generation fleet. Danny Glover and Casey Shelton then discussed the transmission and distribution functions, with emphasis on the challenges and risks associated with building and maintaining a reliable system within the state of Alabama.⁶ These include the relatively low number of customers per line mile, the high incidence of lightning, tornados and hurricanes, and vegetation that is dense and fast-growing. Mr. Glover and Mr. Shelton further explained how Alabama Power meets these challenges, including its industry leading storm restoration efforts.

In the evening session, Jonathan Porter addressed the customer service function, starting with details on the Company's customer base.⁷ He then discussed the many ways in which Alabama Power's customers interface with the Company, including through local offices, customer service centers, web-based applications, and other forms of communications. Mr. Porter also provided examples of the Company's customer service efforts, emphasizing the goal of individualized attention and the involvement of Company personnel in their local

⁵ Mr. Heilbron is the Company's Senior Vice President and Senior Production Officer.

⁶ Mr. Glover is Vice President – Distribution and Mr. Shelton is the Business Manager for the International Brotherhood of Electrical Workers, System Council U-19.

⁷ Mr. Porter serves as the Company's Director of Customer Service.

communities. Following Mr. Porter's presentation, members of the public were afforded an opportunity to address the Commission regarding any topic that concerned them. Nearly two dozen people took advantage of this opportunity, addressing matters that included environmental concerns, economic development, storm and outage restoration, and bills. The vast majority of the speakers were supportive of Alabama Power, particularly with regard to the Company's reliability and customer service.

As with the first meeting, none of the other participants proffered witnesses to give testimony on the topics discussed at these two sessions, and there was minimal questioning of the Company's witnesses.

The fourth public proceeding was held in Montgomery on July 17, 2013. The topics noticed for this day entailed an economic overview, a more detailed presentation of the Rate RSE formula, and presentations on relevant financial considerations, including the Company's capital structure, risk profile, competitive posture, and rate of return. Alabama Power's presentation began with Maria Burke, who provided an overview of the Alabama economy and discussed how economic and other considerations (notably weather) impact the Company's revenue forecast, which is an input to the formulary mechanism under Rate RSE.⁸ As part of that discussion, she addressed the misconception that bills and rates are one in the same. Specifically, Ms. Burke explained that bills are the combination of rates and usage. While the Company's price is below the national average, electricity usage in the state is relatively high. She then proceeded to demonstrate that electricity is the predominant energy choice among

⁸ Ms. Burke is a Manager in the Company's Marketing Department.

Alabama consumers and that, when all forms of energy are considered, Alabamians are among the most efficient energy consumers in the country.

Following Ms. Burke, Eddie Easterling and Wendy Hoomes provided additional details regarding the application of the formula process set forth in Rate RSE.⁹ Mr. Easterling explained how the jurisdictional allocation study required under the rate identifies costs attributable to retail (as opposed to wholesale) service that are properly recoverable from retail customers. He also discussed the different cost categories: demand-related, energy-related and customer-related. Ms. Hoomes described the major expense components recovered under Rate RSE (depreciation and amortization, taxes, and operation and maintenance), and also explained the difference between expenses and capital expenditures. Finally, Ms. Hoomes emphasized certain costs that are explicitly excluded from Rate RSE, and hence have no impact on retail rates.¹⁰

A number of participants posed questions to this panel of witnesses, including AARP, PACE, GASP/SACE, the League of Women Voters, AEC and Manufacture Alabama. In response to questions that were germane to Rate RSE, the panel explained how the jurisdictional allocation study employs industry standard allocation processes and is independently verified by staff. The panel also discussed how many of these aspects of Rate RSE are publicly available, including the annual filing under Rate RSE and the jurisdictional allocation study. The panel did acknowledge that, while Alabama Power's retail electric price was below the national average in 2011, the Company's residential price was higher than the average residential prices of other

⁹ Mr. Easterling is a Manager in the Company's Regulatory Department and Ms. Hoomes serves as the Company's Assistant Comptroller.

¹⁰ Lobbying expense, donations, and civic club dues are not recoverable through Rate RSE. In addition, one-half of Alabama Power's advertising expenses recorded in FERC Accounts 909 and 930.1 are disallowed for recovery through Rate RSE.

southeastern states at that point in time. The panel also emphasized that energy consumers in Alabama continue to recognize that electricity is a good value, as indicated by their choice of electricity over other forms of energy.

Following this panel, David A. Schlissel offered testimony on behalf of Alabama ARISE.¹¹ Mr. Schlissel explained what he viewed to be shortcomings of Rate RSE and the utilization of the formulary rate mechanism. He testified that the circumstances which led to the adoption of Rate RSE no longer exist today. He also stated that there is no opportunity for public scrutiny of Rate RSE or evidence that staff reviews the inputs to the Company's annual Rate RSE submissions. He then claimed that Rate RSE does not lead to lower rates, relying on comparisons he had performed to support this opinion. Mr. Schlissel concluded his testimony stating that the Commission should use what he called more traditional forms of ratemaking with increased public participation.

Upon completion of his testimony, Mr. Schlissel was questioned by a number of participants. In response to questions from the Chief Administrative Law Judge, Mr. Schlissel admitted that his understanding of Alabama law, including the legal protections, rights and powers bestowed upon the Commission and customers under Title 37 of the Alabama Code, was somewhat uninformed. Mr. Schlissel conceded that the recommendations he had put forth were advanced despite his lack of understanding concerning the aforementioned provisions of Alabama law.

In response to questions from Alabama Power, Mr. Schlissel further conceded that criticisms made of the Commission's staff were without any specific evidentiary support, but

¹¹ Mr. Schlissel is President of Schlissel Technical Consulting, Inc., a firm that addresses financial, economic and engineering issues in the fields of energy and the environment.

instead were predicated solely on his lack of information. He did not testify that the Commission staff was failing to do its job in any respect, and disclaimed any intent to suggest otherwise. In addition, Mr. Schlissel admitted that certain comparisons he had performed misstated Alabama Power's competitive price position, and that the utilization of, as he described it, more traditional ratemaking methods did not ensure lower rates. In fact, it was pointed out to Mr. Schlissel that, more often than not, jurisdictions with such methods had rates higher than those of Alabama Power.

Next, AARP presented its witness, Stephen Hill.¹² After distributing a booklet of prepared testimony and workpapers, Mr. Hill testified that Alabama Power is earning too much profit under the current return on equity ("ROE") range of 13.0 to 14.5 percent, given the prevailing economic conditions. Mr. Hill opined that a reasonable estimate for the Company's ROE is approximately 9.0 percent, based on a range of 8.5 to 9.25 percent. Mr. Hill predicated his opinion on the cost of equity capital for what he considered to be similar-risk utility operations using the Discounted Cash Flow ("DCF"), Capital Asset Pricing Model ("CAPM") and Risk Premium ("RP") analyses.¹³ However, Mr. Hill did not recommend the Commission adopt the results of his computations. Instead, he recommended that the Commission set the Company's equity return at 10.0 percent, calling the figure an effort on AARP's part to be

¹² Mr. Hill is a Principal of Hill Associates, a consulting firm specializing in financial and economic issues in regulated industries.

¹³ As we explained in our August 9, 2013 Report and Order involving Mobile Gas Service Corporation (Docket No. 28101), the DCF method is based on the theory that the intrinsic value of a stock is the present value of its expected dividend stream, expressed as the expected dividend yield plus a growth component. The RP method recognizes that an equity investor demands a return in excess of that offered by a "risk free" investment to compensate for the additional risk being assumed, and is expressed as the risk-free rate plus a risk premium. CAPM is a refinement of the RP that recognizes investors evaluate an investment and its expected return in terms of its riskiness relative to the market as a whole. The traditional CAPM applies a company-specific adjustment for risk (beta) to the market risk premium and adds the result to the forecasted risk-free rate.

“conciliatory” and in line with the average returns on equity in the utility industry as well as his recommendation in the recent Mobile Gas proceeding. Significantly, Mr. Hill did not offer any corresponding adjustment to Alabama Power’s equity ratio. Rather, he applied his recommendation of a 10.0 percent equity capital cost to Alabama Power’s actual average capital structure (over the most recent five quarters) to derive a recommended overall cost of capital of 6.88 percent.

Mr. Hill also addressed what he believed to be positions of Alabama Power. First, he stated that an examination of the Company’s overall capital structure was not very informative, and that an equity investor is interested only in the cost of equity, not a blended cost of equity and debt. Second, Mr. Hill criticized the approach being utilized by Alabama Power’s witness Dr. Michael Vilbert. Among other things, he noted that Dr. Vilbert’s analysis, which focuses on the after-tax weighted cost of capital (“ATWACC”), had not been adopted by any jurisdiction in the United States. He also asserted that Dr. Vilbert’s analysis would produce inequitable results in situations where a utility’s stock was trading below book value, and accordingly, an analysis utilizing ATWACC was unreliable for all purposes.

During the questioning that followed, Mr. Hill agreed with Alabama Power that a company’s cost of capital is affected by risk, and that generally speaking, a vertically integrated electric utility like Alabama Power has more business risk than a gas distribution utility such as Mobile Gas. He further agreed that a more highly leveraged company has more financial risk than one with more equity, and that higher financial risk translates into a higher required ROE. Mr. Hill also testified that the cost of debt is less than the cost of equity, but that ultimately the customer is largely indifferent insofar as what percentage of the customer’s bill pays equity costs

and what pays debt costs. In his view, the overall structure of debt and equity is more appropriately a matter for Commission concern. The customer, Mr. Hill emphasized, is concerned about keeping rates low.

Other participants questioned Mr. Hill regarding recommendations he had given before the Missouri Public Service Commission that were determined to be unreliable and lacking credibility. Specifically, that commission found Mr. Hill's proposed return to be an "outlier" and suggested that the figure was derived in part to facilitate his client's negotiating position. In response to this line of questions, Mr. Hill stated that the Missouri commission's treatment of his recommendation was consistent with its treatment of other recommendations that fell outside a targeted band. As to the suggestion that he had tailored his results to support a particular position, Mr. Hill stated that he had simply relied upon the results of his models and that his recommendation had not been tailored for negotiating purposes.

Following AARP's presentation, Alabama Power presented witnesses who testified to the reasonableness of the Company's return range and the attendant financial considerations relevant to such an assessment. First, Chris Blake provided an analysis of Alabama Power's overall return, using actual information for each component of its capital structure.¹⁴ As part of this presentation, Mr. Blake emphasized that all aspects of a company's capital structure must be taken into account when considering the reasonableness of any one component. Mr. Blake also explained the following:

- Two companies can have vastly different capital structures, but still have the same overall return.

¹⁴ Mr. Blake is the Company's Assistant Treasurer.

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- Rate RSE recognizes a connection between ROE and equity ratio, as evidenced by the inclusion of a provision imposing certain limitations on the amount of equity to which the allowed ROE can be applied.
- Customers benefit when a company can access the capital markets at favorable terms that yield low interest rates. A strong credit rating, like that possessed by Alabama Power, facilitates access to the markets at such terms.
- The Company's equity ratio of approximately 44 percent is markedly below that of other comparably rated utilities, which have an average equity ratio of 55 percent.
- Customer rates reflect a company's overall return. As long as that overall return is reasonable, customers should be indifferent as to the composition of that overall return.

Mr. Blake completed his presentation by comparing Alabama Power's historical weighted costs of debt and equity over a 15-year period (1998-2012), as well as its overall return on invested capital, with those of a peer group of 27 utility companies. This group, which Alabama Power developed in 2012 as an outgrowth of the Commission's staff oversight, was derived using a statistical approach called a cluster analysis. Alabama Power applied the cluster analysis to identify comparable companies using specified company data involving investment and scale, operations, and financial considerations. When compared with this group of peer companies, Alabama Power's weighted cost of equity, weighted cost of debt and overall return were all shown to be within a range of reasonableness.

Dr. Michael Vilbert next presented on behalf of Alabama Power.¹⁵ Dr. Vilbert testified as to the reasonableness of Alabama Power's overall return, including the equity return range reflected in Rate RSE. He supported his conclusions through the presentation of a market-based analysis, which utilized an after-tax weighted average cost of capital ("ATWACC") to estimate

¹⁵ Dr. Vilbert is a Principal with The Brattle Group, an international consulting firm that provides expert services in economics, finance and regulation.

the investor required return. Dr. Vilbert explained that the ATWACC methodology is predicated on certain fundamental economic principles.

- The capital market establishes the investor-required return based on an assessment of the business and financial risk of a company.
- Financial risk is primarily a function of the capital structure, with a lower equity ratio giving rise to more financial risk.
- Higher financial risk means a higher investor required return.
- Within certain bounds, financial risk can be managed by adjusting the capital structure without affecting the ATWACC.
- Customers are unaffected by the individual components of a company's capital structure, as long as the ATWACC does not change.

The ATWACC analysis recognizes that cost of equity estimates, as derived from market data, reflect the amount of financial risk associated with the market value capital structure of the subject companies. In order to obtain meaningful conclusions from cost of equity estimates of a sample group, differences in capital structure (which correspond with differences in financial risk) must be reconciled. To accomplish this, ATWACC applies the following formulation:

$$ATWACC = [ROE * (Market\ Equity\ Ratio)] + [Cost\ of\ Debt * (1 - Tax\ Rate) * (Market\ Debt\ Ratio)]$$

Dr. Vilbert employed three models for deriving the ROE component of the formulation: DCF, DCF multi-stage and empirical CAPM ("ECAPM").¹⁶ The balance of the ATWACC calculation

¹⁶ As explained by Dr. Vilbert, the simple DCF applies a single projected growth rate (as published by investor advisory services) for the company under study, while the multi-stage DCF relies on that projected growth rate for the first five years, and thereafter uses projected growth in GDP. With respect to the ECAPM, Dr. Vilbert demonstrated that the theoretical CAPM produces results that are inconsistent with the relationship found in empirical studies. Specifically, CAPM understates the premium for low beta stocks and overstates the premium for high beta stocks. Dr. Vilbert's ECAPM analysis addresses this inherent bias. Following the completion of proceedings, Alabama Power filed Dr. Vilbert's workpapers with the Commission.

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uses public data to determine the market capitalization, incremental debt cost and applicable composite tax rate.

In order to evaluate the reasonableness of Alabama Power's overall return, Dr. Vilbert developed a comparable group of 68 companies in capital intensive industries that compete with Alabama Power in the capital markets. That peer group largely comprised utilities, but also included other companies that rely on a network of assets to provide services to residential, commercial and industrial customers. Using the three ROE models, Dr. Vilbert derived the ATWACC for each of these companies and averaged the results. He then compared these results with Alabama Power's projected overall return (after-tax) of 7.26 percent, which was calculated using information taken from the December 2012 filing by the Company under Rate RSE. Alabama Power's overall return proved to be in line with the results from the comparable group, which were as follows:

<i>Average of Top 25%</i>	<i>8.47%</i>
<i>Average of Top 50%</i>	<i>7.69%</i>
<i>Average of Top 75%</i>	<i>7.20%</i>
<i>Average</i>	<i>6.80%</i>

APC = 7.26%

Going further, Dr. Vilbert offered additional validation through his application of an "excess earnings" methodology that has been adopted in the state of Ohio and which he regularly performs on behalf of utilities in that jurisdiction. Under this test, a range is developed for ROE using comparable companies. A utility's actual ROE is deemed to be reasonable if it is within that range. Dr. Vilbert subjected Alabama Power's allowed range under Rate RSE to this test

and found that entire range to be reasonable. Based on the ATWACC analysis and the excess earnings test, Dr. Vilbert concluded that the current structure under Rate RSE – including both the ROE range and the overall return – is fair and reasonable.

Alabama Power closed its presentation with testimony from Steven M. Fetter.¹⁷ Echoing earlier comments by Mr. Blake, Mr. Fetter emphasized that regulation is a key factor in the process of utility credit analysis and formulation of individual utility credit ratings. Mr. Fetter explained how these ratings significantly affect a utility's ability to raise capital on a timely basis and on favorable terms. The ratings also communicate to investors (both debt and equity) the financial strength of a company and the underlying credit quality of its debt securities.

While corporate credit ratings analysis considers both qualitative and quantitative factors, Mr. Fetter stressed that in his experience, the quality of regulation (*e.g.*, reasonableness and consistency) is the dominant consideration in this process. In this regard, he observed that outside industry analyst Regulatory Research Associates ranks Alabama regulation "Above Average 2." He also reiterated Mr. Blake's statements that the credit rating agencies (Standard & Poor's, Moody's and Fitch)¹⁸ all rank Alabama Power consistently in the "A" or equivalent category, and that such strong ratings directly translate into benefits for customers.¹⁹ Finally, he cautioned against taking action on Alabama Power's Rate RSE without a full consideration of capital structure. Among other things, doing so could result in unintended consequences such as

¹⁷ Mr. Fetter, President of Regulation UnFettered, is the former Chair of the Michigan Public Service Commission and former Utility Group Manager with Fitch Ratings. In his current role, he provides financial, regulatory, legislative and other advisory services.

¹⁸ Fitch and Moody's rank Alabama Power as a stand-alone company, whereas Standard & Poor's rates Southern Company on a consolidated basis.

¹⁹ These benefits are long-lasting in nature, in that a debt instrument carries its favorable interest rate over the entirety of its term. Similarly, if a company's credit rating is lower, the less favorable interest terms can burden customers with higher costs for many years.

a downgrade of the Company's credit rating and an increase in both the cost of debt and equity financings – events from which the Company could not be expected to readily recover.

Following these presentations, some of the other participants, largely AARP, asked questions of the panel. The majority of the questions focused on the business and financial risks of Alabama Power relative to other companies and whether the Rate RSE mechanism mitigated such risks. Mr. Blake pointed out that, while Rate RSE is predicated on forward-looking projections, the Company's earned return is a function of actual operating experience that can deviate significantly from projections for reasons such as weather and economic conditions. In this regard, Dr. Vilbert noted the asymmetrical nature of Rate RSE, which would produce refunds for customers in the event actual earnings exceeded the allowed range, but would afford no corresponding relief to the Company in the event circumstances did not produce a return that reached the bottom of the range.

Dr. Vilbert was also questioned about the acceptance of ATWACC in other jurisdictions. He conceded that, with few exceptions, his approach has not been adopted in the United States, but he observed that a number of foreign jurisdictions, including Australia, Canada and New Zealand, employed the ATWACC. According to Dr. Vilbert, ATWACC was developed subsequent to the adoption of other approaches, which has impeded its acceptance domestically. That does not, however, detract from the fact that ATWACC is consistent with economic theory and properly accounts for differences in financial risk, and hence cost of equity, resulting from the market-value capital structure.

After questioning of this panel was concluded, PACE made an offer of proof respecting its potential rebuttal witness, Don J. Wood.²⁰ PACE explained that it was not going to present the witness given that prior testimony had already demonstrated the effectiveness of the Commission and its staff in overseeing and regulating Alabama Power and Rate RSE. Moreover, while his methodologies may have differed, Mr. Wood would have offered conclusions regarding the reasonableness of Alabama Power's ROE and overall return consistent with those of Mr. Blake, Dr. Vilbert and Mr. Fetter.

The Commission concluded the public proceedings for Alabama Power by again receiving public input concerning the utility, its services and rates, and allowing the participants a final opportunity for closing comments. These comments were consistent with remarks or position statements submitted during the course of these proceedings.

III. Discussion

At the outset, it seems appropriate to comment on those matters upon which all appear to be in agreement. First, every participant to these proceedings recognizes the quality of electrical service delivered by Alabama Power. By all accounts, the Company's storm recovery capabilities are second to none, and the reliability of the generation, transmission and distribution functions is very high. These and other aspects of the Company's commitment to service translate into customer satisfaction levels that are repeatedly among the highest in the industry. Moreover, as evidenced by the repeated public commentary to this effect, the Company is a proven leader in economic development and job creation for the state of Alabama.

²⁰ Mr. Wood is a principal in the firm of Wood & Wood. He provides economic, financial and regulatory analysis services in technology-driven industries, specializing in economic policy related to the development of competitive markets, cost of service issues and the calculation of financial damages.

Second, there is no dispute that our staff has and continues to diligently monitor and oversee the operations of Alabama Power. This oversight assumes many different forms and involves all kinds of activities, both formal and informal, and both public and non-public. In like manner, there is no question as to the competence, knowledge and commitment of staff.

Given the foregoing, three fundamental questions are before the Commission: (i) whether the return on equity range set forth in Rate RSE continues to be fair and reasonable; (ii) whether Rate RSE should be modernized in any respect; and (iii) whether other changes should be made to the procedures associated with Rate RSE. We will address these in turn.

A. Rate RSE and the Allowed Return

Based on the information that has been presented to the Commission, we are convinced that the current return range and the overall allowed return have been and remain reasonable.

From a historical perspective, the Company showed that the primary components of its capital structure (weighted cost of equity and weighted cost of debt), as well as the overall return, are bracketed by peer results. It did so through a granular consideration of actual results in the specific context of peer companies. This historical data spanning a 15-year period reflects notable stability – which is a goal of Rate RSE – and on its own offers much in the way of assurance that the rate, at least in the near future, is unlikely to produce unreasonable results. AARP witness Mr. Hill did make passing reference to historical average allowed returns and the fact that those returns have trended downward with time, citing a chart depicting allowed returns (to the extent available) for regulated utilities in the United States, without regard to comparability. In noting a downward trend in allowed returns, however, Mr. Hill neglected to acknowledge an offsetting increasing trend in common equity ratios among companies in the

industry over the same period. For purposes of this proceeding, we find the Company's historical presentation to be more compelling.

Shifting to prospective assessments, the Commission has before it dueling positions by expert witnesses concerning the reasonableness of the Company's ROE and overall return. As noted earlier, Mr. Hill recommends setting Alabama Power's ROE at 10 percent. Dr. Vilbert, on the other hand, finds the current ROE range to be reasonable and requiring no change.²¹

We are not persuaded by Mr. Hill's presentation or inclined to accept his recommended return.²² To begin with, Mr. Hill does not appear to account adequately for the unusual economic conditions that prevail in today's markets. This is particularly so as to artificially low interest rates, which Mr. Hill appears to believe represent normal conditions for the foreseeable future. We also do not find Mr. Hill's analysis to sufficiently account for the Company's materially different capital structure and favorable credit rating. Thus, he does not adequately recognize the financial risk faced by the Company and its associated impact on the investor-required return. Moreover, he appears to correlate the Company's successful management of financial risk with an absence of such risk. From a business risk perspective, he appears to underestimate the challenges of operating a large, vertically integrated utility with a large industrial customer base, and he either minimizes or ignores other significant risks, such as future federal regulations and the unpredictable effects of weather and the economy. Finally, in

²¹ In addition, counsel for PACE indicated that its expert rebuttal witness Mr. Wood would have testified in support of the existing ROE range under Rate RSE.

²² In addition to deficiencies noted elsewhere in this report, Mr. Hill's recommendation of a 10.0 percent return on equity is rendered suspect by the fact that it would produce an overall return for Alabama Power of 6.88 percent. This overall return would be approximately 48 basis points lower than the lowest return reported by SNL for comparable utilities based on their most recent rate case decisions over the period 2009-January 2013. Such a result raises serious questions regarding the adequacy of Mr. Hill's recommendation under Alabama law.

our view, Mr. Hill too quickly dismisses the potential impact of his proposed recommendation on Alabama Power's credit rating. In this regard, he fails to appreciate the credit rating process, particularly the qualitative aspects, by focusing on interest coverage to the virtual exclusion of all other factors.²³ He also appears to assume that a credit downgrade, if triggered by the adoption of his recommendation, could readily be reversed or would have minimal impact on customers.

These and other weaknesses in Mr. Hill's position became even more apparent over the course of the presentations from Dr. Vilbert and Mr. Fetter. Unlike Mr. Hill's analysis, the ATWACC approach used by Dr. Vilbert reconciles different capital structures, thereby allowing an "apples to apples" comparison. By focusing on an overall return on capital instead of ROE, the ATWACC accounts for differences in financial risk between Alabama Power and the sample companies, in that – like customers – it is indifferent to the manner in which management chooses to allocate that risk between debt and equity, so long as the overall return is the same. The Commission recognizes that the ATWACC analysis is not a prevalent methodology in the United States; however, the focus of that methodology on the relationship between the market value and the associated financial risk of the utility is compelling. This is especially true in a proceeding such as this, which is not seeking to establish a return *de novo*, but rather analyzing the reasonableness of the return incorporated in an existing rate.

Other points persuasively made by the Company's witnesses bear on our assessment of Mr. Hill's recommendation. For example, Dr. Vilbert discussed the artificially low and volatile interest rates, further noting that lower interest rates do not reduce the unique challenges facing the electric utility industry. Indeed, he demonstrated that the utility industry has become more

²³ These other factors would include, for example, regulatory framework, ability to recover costs and earn returns, diversification, market position, generation and fuel diversity, and other key financial metrics.

risky in recent years, with the level of capital expenditures increasing in the face of a declining rate of growth in customer demand. This observation was echoed by Mr. Blake and is one that this Commission itself is well aware of, given our familiarity and that of our staff with the operations of the Company. Finally, all three of the Company's witnesses, and in particular Mr. Fetter, emphasized the direct and material benefit to customers resulting from the Company's strong credit rating. Speaking as a former rating analyst, Mr. Fetter made clear that Mr. Hill's recommendation would, if adopted, jeopardize that credit rating and expose Alabama Power's customers to higher interest costs.

In sum, considering the record and all other information that is available to us, we conclude that the existing ROE and overall return in Alabama Power's Rate RSE continue to be fair and reasonable. The reasonableness of these aspects of the rate has been demonstrated on a historical and forward-looking basis. The returns are bracketed by peer results for comparable companies and do not yield excessive profits for Alabama Power.

B. Modernization of the Rate RSE Formula

The fact that we conclude Rate RSE, the prescribed ROE range and Alabama Power's overall return continue to be just and reasonable does not mean that the rate would not benefit from certain modernizations. Over the course of the proceeding, it became evident that Alabama Power is more highly leveraged than most other utility companies. Indeed, those utility companies with a credit rating equivalent to Alabama Power have an average equity ratio of approximately 55 percent. By comparison, Alabama Power's current equity ratio is slightly below 44 percent, and is limited by the terms of Rate RSE with respect to equity levels above 45 percent.

The financial witnesses that testified during these proceedings were in agreement regarding the relationship between the capital structure of a company and its relative financial risk from a market perspective. All things being equal, a company with a lower equity ratio has more financial risk than a company with a higher equity ratio, thus requiring a higher ROE to compensate equity investors for that additional risk. As the amount of equity increases, however, the amount of financial risk decreases, thus resulting in a lower investor-required ROE. Rate RSE in its current form recognizes this important relationship between ROE and equity ratio through the aforementioned constraint on capital eligible for earnings at the specified ROE range. While this relationship should continue to be reflected in provisions of Rate RSE, we believe there is a more effective method than the current approach. This is because, under the current provision, customers are exposed to potential increases in revenue requirements arising from normal growth in common equity attributable to retained earnings.

An improved construct would be to recognize the importance of capital structure by linking the Company's equity ratio to the allowed return so that changes in the equity ratio (with the associated implications in terms of financial risk) would be reflected in the ROE permitted to be earned by the Company. This can be accomplished rather easily by eliminating both the ROE range and the provision restricting the equity ratio, and replacing them with a range reflecting an allowed weighted cost of equity ("WCE").²⁴ In essence, the WCE would be fixed within a range, thereby providing another level of rate stability for customers. If implemented by the Company, this refinement would maintain a fair return, establish a proper balance between the

²⁴ As a technical matter, we recognize that Rate RSE currently speaks in terms of return on retail common equity ("RRCE"). Should the Company adopt our recommendation, we expect that it would describe the WCE in comparably technical terms.

interests of the Company and its customers, and afford management the flexibility to do what is necessary to maintain a strong credit rating and other metrics that produce such positive benefits for customers so long as the Company operates within parameters that appear to the Commission to be reasonable and appropriate based on prevailing circumstances and conditions.

Using the existing Rate RSE framework, the allowed ROE range (13.0-14.5 percent, with an adjusting point of 13.75 percent) and allowed equity ratio (45 percent) translate into a reasonable WCE range of 5.85-6.53 percent, with an adjusting point of 6.19 percent. Through such a unified assessment of ROE and equity ratio – which would continue to occur annually pursuant to the existing provisions of the rate – the Company would have the ability, as needed, to increase the percentage of equity in the business, but doing so would result in a reduction in the return on that equity. Customers would thus remain indifferent from the standpoint of the allowed ROE. This is because, under the WCE approach, an increase in the equity ratio would by definition result in a lower allowed equity return.

Even though the Company's current return – considering all of the interactive component parts – has been shown to be reasonable, it is clear that many customers are struggling as the Alabama economy continues to recover from the recession. This was demonstrated not only through presentations by the Company, but also by other participants as well as members of the public. While Alabama courts have made it clear that such factors cannot be the basis for a rate order by this Commission, we certainly have the authority to recommend matters for the Company's consideration and independent adoption. And in this regard, this Commission believes that it would be beneficial to customers if the Company could share at least some of the ongoing burden, without impacting its ability to provide reliable service, by lowering the WCE

range, thereby giving up some of its current earnings potential and reducing the revenue requirement to be recovered from customers going forward.

For these reasons, it is our recommendation that Alabama Power modify Rate RSE to eliminate the current ROE range and the provision regarding capital structure, and replace them with a lower WCE range of 5.75-6.21 percent, with an adjusting point of 5.98 percent. In addition, for years in which the Rate RSE mechanism produces a revenue adjustment, the Company shall be eligible to receive a performance-based adder of 7 basis points (0.07%) to the adjusting point, if at least one of the following two conditions is satisfied as of the time of the annual Rate RSE filing: (i) the Company possesses an “A” credit rating equivalent with at least one of the recognized rating agencies;²⁵ or (ii) the Company is in the top third of the customer value benchmark survey that is examined by staff as part of its most recent annual metrics review.²⁶

In making this recommendation, we would emphasize that our goal here is to solidify the Commission’s recognition of the importance of capital structure and the relationship between equity ratio and an appropriate ROE by incorporating those dynamics more directly in the Rate RSE formula. We should not be understood as finding that the existing structure is in any way inadequate or defective. Rather, with the benefit of the information adduced during these public

²⁵ There are currently three such rating agencies: Fitch, Moody’s and Standard & Poor’s. By “A” equivalent, we mean a rating in any of the “A” subcategories for long-term debt maintained by these agencies. For purposes of this condition, the consolidated S&P rating for Southern Company shall be applicable to Alabama Power.

²⁶ This benchmark survey is conducted by third party consultants, under the direction of Southern Company Services, on behalf of the Southern operating companies. It reflects a compilation of feedback from residential, commercial and industrial customers across comparable utilities, and is directed to key value drivers such as pricing/cost, reliability, customer service skills, program/energy efficiency information, billing and pricing options, and outage communications.

proceedings, we are of the view that a transition to WCE would be a superior means of achieving these ends.²⁷

C. Changes to Other Procedures Associated with Rate RSE

The final item for our consideration relates to the need for Rate RSE to reflect any other processes or conditions that would enhance its operation and utilization. Several participants made generalized recommendations to the Commission that it adopt more transparency in connection with the operations of Alabama Power.²⁸ Others, such as the Office of the Attorney General, offered more specific suggestions as to what additions might be included in the Rate RSE process. For the reasons that follow, we recommend the Company consider implementing the following procedures, along with the other modifications to Rate RSE that we have proposed elsewhere in this report.

As to the generalized suggestion that customers lack adequate information regarding the Company's operations, we would note that Alabama Power is required by law and regulation (including the requirements of this Commission set forth in the governing rules and rates) to publish a vast array of detailed reports and data related to its business activities. These include the myriad of forms required by the Securities and Exchange Commission (*e.g.*, Form 10-K, Form 10-Q, Form 8-K and registration statements) and by the Federal Energy Regulatory Commission (*e.g.*, Form 1, Form 714, Form 715, and electronic quarterly reports), among others.

²⁷ Should the Company accept this recommendation and revise Rate RSE accordingly, we would expect changes of a conforming nature to the other rate schedules that reference Rate RSE as part of their formulary calculations (*i.e.*, Rate CNP, Parts A and C) and a description by the Company of how it proposes to use the WCE to derive the equity return component for purposes of calculating AFUDC.

²⁸ Many of these requests concerned topics beyond the scope of the proceedings noticed for review, such as resource planning, environmental compliance or the abandonment of the Rate RSE formulary mechanism. Of particular note, the testimony of ARISE witness Mr. Schlissel was largely focused on the elimination of Rate RSE in its current form in favor of the adversarial rate hearing process that this Commission previously has concluded is ineffective and not in the best interests of Alabama utility customers.

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As discussed by our staff, the Company likewise is required to make a number of annual filings with this Commission, including a comprehensive operational and financial report (Form 1), a cost of service study, an environmental compliance plan, and the end-of-year Rate RSE filing. The Company also makes periodic filings. For example, Alabama Power conducts a depreciation study that is publicly filed with FERC and submitted to staff for review and analysis. In addition, a public filing and procedure are required when the Company petitions for a certificate of convenience and necessity under Alabama Code § 37-4-28, with all associated due process rights for interested parties. As discussed during the proceedings, the Company also is required under Rate RSE to hold a public meeting in December of each year to provide an overview of the submittal made pursuant to the rate, discuss significant cost drivers affecting the Company, and answer questions posed by staff, the Office of the Attorney General and interested persons. A similar meeting is held on the same day, which focuses on environmental compliance and related issues. This too is open to the public, providing interested persons with an opportunity to pose questions to Alabama Power's representatives.

These filings and processes are separate and apart from the continuous and timely exchange of information between Alabama Power and the Commission in conjunction with staff's oversight and monitoring activities. As staff explained, information requests to the Company assume any number of different forms, ranging from scheduled submissions, to data requests to less formal meetings and communications. Regardless of form, the Company is wholly forthcoming in its provision of information responsive to staff inquiries, a fact confirmed by staff during the first meeting in these public proceedings. Of course, the vast majority of this information is not intended for public disclosure, in that it reflects sensitive and proprietary data

that, if revealed, could impair the Company's ability to provide cost-effective service to its customers. Our access to this information, however, is appropriate and necessary given our role as the administrative body charged with regulating Alabama Power in accordance with the law.

Given the foregoing, we are of the view that the public is already afforded reasonable transparency concerning the books, records and operations of Alabama Power. We see no reason to encumber Rate RSE with additional procedures in this regard, as suggested generally by certain participants. Moreover, we believe that doing so would be counterproductive to the goals and purposes of Rate RSE and could return us to adversarial and protracted proceedings that the rate was designed to avoid.

Drawing from suggestions that the Office of the Attorney General asked us to consider, we recommend that the staff's annual metrics review should include a representative from the Office of the Attorney General. In addition, we recommend that the Company consider implementing the following components to the Special Rules Governing Rate RSE. These suggested expansions, if implemented, would be in addition to, and not in lieu of, all existing authority of the Commission, and would not impair the right of the Company to make filings or petitions with the Commission as allowed by law.

First, while we recognize Alabama Power's Rate RSE already requires considerably more detail in its annual filing than was required for Mobile Gas, we believe that customers and other interested persons would benefit from a strengthening of the Company's annual filing requirements. To this end, we recommend that, beginning in 2014, the Company make semi-annual filings of its most current actual income statement and balance sheet. The form of these submissions would be along the following lines: (1) a submission around the March timeframe of

the Company's income statement and balance sheet for the preceding year (*e.g.*, Jan.-Dec., 2013), along with corresponding information for that same period, one year prior (*i.e.*, Jan.-Dec., 2012); and (2) a submission around the September timeframe of the Company's income statement and balance sheet for the first six months of the current year (*e.g.*, Jan.-June, 2014), along with corresponding information for that same period, one year prior (*i.e.*, Jan.-June, 2013). Alabama Power would make these semi-annual filings within a reasonable period after the corresponding release of this information and in a form consistent with all applicable SEC requirements.²⁹

Second, we recommend that, in addition to staff's ongoing oversight, an objective, self-executing mechanism, similar to that which we have recommended for Mobile Gas, be put in place that would prompt additional scrutiny of the Company's allowed return. Using a baseline interest rate equal to the 12-month average for 30-year U.S. Treasury Bonds as of the date of this report, additional review would be triggered in the event the rate for 30-year U.S. Treasury Bonds increases by more than 350 basis points or decreases by more than 200 basis points. To make this determination, the baseline interest rate would be tested at the end of each calendar quarter against the most recent 12-month average of 30-year U.S. Treasury Bonds. Such a mechanism seems appropriate because a change in interest rates of the magnitude prescribed

²⁹ With respect to the proposed expansion of the limited complaint process set forth in the Special Rules Governing Rate RSE, we have not encountered anything that suggests to us that the existing procedures in the Special Rules are in any way inadequate or deficient. Moreover, the Special Rules are replete with obligations on the part of the Company to respond to questions from the Office of the Attorney General on virtually all aspects of the Company's operations as they relate to the annual Rate RSE filing. As to the possibility of future management audits, we would note that the basic purpose of such an audit is to assess the effectiveness of a company's management team in executing the strategic objectives and policies of the business. Based on the information received by us during these proceedings, it is clear that Alabama Power's management is effective in promoting the objectives of the business – providing customers with reliable, cost-effective electricity at a reasonable price. Of course, we reserve the right to revisit either or both of these items should there be a material change in circumstances.

could signal a material economic shift and hence the possible need to consider whether the existing range remains appropriate.

Finally, we believe that, every six (6) years, Alabama Power should prepare for staff and the Office of the Attorney General an examination comparable to the historical analysis it presented in this proceeding. This examination would focus on financial and operational considerations including, among other things, all elements of the capital structure and overall return, as compared to a group of peer utilities derived through the cluster methodology, as well as metrics regarding customer service, operational performance, and any other information deemed relevant to the examination. The time frame covered by this analysis should include at least the most recent five years for which the necessary data is publicly available. The first such examination would take place during the annual metrics review for 2019. At the close of the examination, the Company would meet with staff and the Office of the Attorney General to review and discuss the final results. Staff may also perform its own analysis for consideration before notifying the Commission whether or not any further review or action is needed.

IV. Conclusion

It is the conclusion of the Commission that these public proceedings have yielded valuable information and insight that has assisted the Commission in its assessment of the operation and utilization of Alabama Power's Rate RSE. To be sure, the Company's presentations covered familiar matters that the Commission, through its staff, reviews continuously as part of its oversight and monitoring responsibilities. Nonetheless, those discussions provided important context for our review of Rate RSE, not the least of which being an elaboration as to how Rate RSE facilitates Alabama Power's reliable and cost-effective cost

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service to customers and the Company's ability to respond and adapt to changes in the economic and federal regulatory landscapes. Rate RSE continues to serve the goals originally established by this Commission, but we believe that the recommended refinement to adopt a weighted cost of equity in the formula rate mechanism, as well as the additional procedures described above, will enhance the performance of Rate RSE for the benefit of customers while continuing to provide the Company an opportunity to earn a fair return.

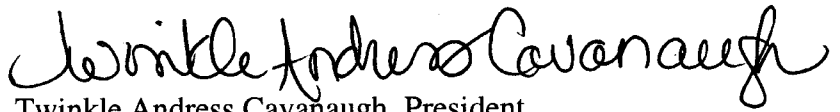
Should Alabama Power consent to the recommendations set forth herein, the Company shall file conforming changes within thirty (30) days of the date of this report. The Commission reserves the right to take no further action on such consent filing and to allow it to go into effect by operation of law if we conclude that the Company has satisfactorily implemented our recommendations. In the event the Company declines to consent, in whole or part, the Commission specifically reserves the right to take further action consistent with the recommendations set forth above and otherwise consistent with Alabama law.

IT IS SO ORDERED BY THE COMMISSION.

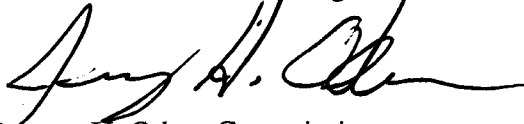
IT IS FURTHER ORDERED BY THE COMMISSION, That jurisdiction in this cause is hereby retained for the issuance of any further order or orders as may appear just and reasonable in the premise.

DONE in Montgomery, Alabama this 21st day of August, 2013.

ALABAMA PUBLIC SERVICE COMMISSION



Twinkle Andress Cavanaugh, President

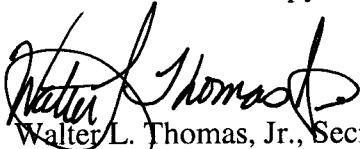


Jeremy H. Oden, Commissioner

*Commissioner Terry L. Dunn voted
no on this matter.

Terry L. Dunn, Commissioner

ATTEST: A True Copy



Walter L. Thomas, Jr., Secretary